Year-end planning:
How to handle capital gains and losses to save taxes

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Introduction. Since the stock market lows in 2009, the stock market has performed so well that it is approaching its pre-recession lows. Bond prices also have risen in the past year as a result of the steep decline in interest rates. Consequently, many persons may be sitting on large gains in stocks, bonds, mutual fund shares and other investment assets. These taxpayers should consider the extent to which they should sell appreciated assets this year to make use of available losses and/or to lock in this year's maximum long-capital gain rate, which may be lower than next year's maximum capital gain rate. For 2010, long-term capital gains are taxed at a maximum rate of 15% (0% to the extent the gain would otherwise be taxed at a rate below 25% if it were ordinary income). By contrast, in the worst case scenario starting next year the Bush tax cuts end, and long-term capital gain will taxed at a maximum rate of 20% (18% for assets held more than five years). We cannot assume that Congress will stir from its lethargy in a lame duck session or that next year gridlock might stop the effective tax rate increase.

Using available losses. Long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must be used to offset short-term capital gains before they are used to offset long-term capital gains. Non-corporate taxpayers may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing AGI.

For 2010, a non-corporate taxpayer is subject to tax at a rate as high as 35% on short-term capital gains and ordinary income. If the Bush tax cuts die at the end of this year, then for 2011, a non-corporate taxpayer will be subject to tax at a rate as high as 39.6% on short-term capital gains and ordinary income. On the other hand, for 2010, most long-term capital gains are taxed at a maximum rate of 15%. For 2011, they will be taxed at a maximum rate of 20% if the Bush tax cuts die (18% for assets held more than five years).

A taxpayer should try to avoid having long-term capital losses offset long-term capital gains since those losses will be more valuable if they are used to offset short-term capital gains or ordinary income. To do this requires making sure that the long-term capital losses are not taken in the same year that the long-term capital gains are taken. However, this is not just a tax issue. As is the case with most planning involving capital gains and losses, investment factors need to be considered. A taxpayer won't want to defer recognizing gain until the following year if there's too much risk that the value of the property will decline before it can be sold. Similarly, a taxpayer won't want to risk increasing the loss on property that he expects will continue to decline in value by deferring the sale of that property until the following year.

To the extent that taking long-term capital losses in a different year than long-term capital gains is consistent with good investment planning, the taxpayer should take steps to prevent those losses from offsetting those gains.

If a taxpayer has no net capital losses for 2010, but expects to realize such losses in 2011 well in excess of the $3,000 ceiling, he should consider shifting some of the excess losses into 2010. That way the losses can offset 2010 gains and up to $3,000 of any excess loss will become deductible against ordinary income in 2010.

How to preserve investment position after recognizing gain or loss on stock. For the reasons outlined above, paper losses or gains on stocks may be worth recognizing this year in some situations. But suppose the stock is also an attractive investment worth holding onto for the long term. There is no way to precisely preserve a stock investment position while at the same time gaining the benefit of the tax loss, because the so-called "wash sale" rule precludes recognition of loss where substantially identical securities are bought and sold within a 61-day period (30 days before or 30 days after the date of sale). Thus, a taxpayer can't sell the stock to establish the tax loss and simply buy it back the next day. However, he can substantially preserve an investment position while realizing a tax loss by using one of these techniques:

- Double up. Buy more of the same stocks or bonds, then sell the original holding at least 31 days later. The risk here is of further downward price movement.
- Sell the original holding and then buy the same securities at least 31 days later.
- Sell the original holding and buy similar securities in different companies in the same line of business. This approach trades on the prospects of the industry as a whole, rather than the particular stock held.
- In the case of mutual fund shares, sell the original holding and buy shares in another mutual fund that uses a similar investment strategy.

(Note: If you sell at a *gain* and buy the same security within 30 days, the wash sale rules do *not* apply. As a result, a taxpayer may recognize a paper gain on stock in 2010 for year-end planning purposes and then buy it back at any time without having to worry about the wash sale rules.

Taking gains to lock in more favorable rates. If you have large gains and few available losses to offset them you face the difficult choice of whether to realize some gains this year to lock in the 15% rate. At this point in time, there is extreme uncertainty as to whether the maximum capital gain rate will rise at all next year, or will rise only for higher income taxpayers. Because the matter might be resolved before year end by the lame duck Congress (or might not as mentioned above), you might want to examine your portfolio now with the view to determining which assets you would want to sell should it become clear before year end that the capital gains rate will be hiked and, because of your income level, the hike will affect your.

Here, too, investment considerations should rule the day. For example, you might be sitting on sizeable gains in bonds or bond funds. If you feel that interest rates are not going any lower or are going to start rising, it may be good time to realize gains in bonds purely for investment reasons. Thus, such assets may be ripe for sale even if the long-term capital gain rate does not rise. Where there is less concern that assets will remain flat or decline in value, the issue gets trickier. Again, by examining your portfolios now, you will be able to act quickly if and when next year's tax picture becomes clear.

If you have any year end tax planning issues, please feel free to contact us.